

THE EURO BLAME GAME AND ITS IMPLICATIONS FOR POLICY AND FINANCIAL MARKETS

by

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ACES Cases, No. 2012.2

Stephen J. Silvia, American University, editor

* Acknowledgements: I would like to thank Stephen Silvia and participants at the European Communities Studies Association - Canada conference in Ottawa in April 2012 for their valuable comments and suggestions. Funding in support of this research was provided by the European Commission, The American Consortium on EU Studies (ACES) and York University.

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Abstract:

The recent financial crisis in some of the eurozone member countries has received a great deal of attention by investors, policy makers and commentators alike. Often these events are interpreted as a failure of the euro and the sustainability of the eurozone is called into question. This paper shows that this analysis and its emphasis are flawed. Fiscal imbalances and financial market imperfections are at the core of the problem, and they need to be addressed directly to prevent future crises.

Introduction

The recent financial crisis in some of the eurozone member countries has received a great deal of attention by investors, policymakers and commentators alike. Often these events are interpreted as a failure of the euro and the sustainability of the European Monetary Union (EMU) is called into question. I challenge this view by analyzing the causes of the crisis, comparing the fiscal performance of eurozone members to other high-income economies and evaluate some of the policy proposals that have emerged during the unfolding crisis. If these policy proposals do not address the causes of the crisis, they cannot be expected to deal with the problems at hand or to prevent similar crises in the future. Semantics deserve a great deal of attention in this case; assigning blame to the wrong factors and/or creating uncertainty about future policy course can have very real and significant costs in terms of higher borrowing costs for governments (and ultimately taxpayers) as well as sustained volatility in financial markets.

At the heart of the so-called eurozone crisis are high government budget deficits and debt levels leading to re-evaluation of sovereign default risk in a number of countries including Greece, Italy, Portugal, France and others. However, it should be noted that currency crises set off by high public debt levels are not a new phenomenon. For example, the experience of countries like Argentina, Brazil and Mexico in the 1970s and 1980s generated an extensive literature on the subject of currency crises.¹

¹ See e.g. Flood and Marion (1999) for an overview of the literature on *first-generation* and *second-generation* currency crisis models with multiple equilibria.

The Asian crisis of 1997 nevertheless came as a surprise to investors since analysts looking at public debt and deficits for warning signs did not find any. The south Asian countries had their public finances in order, but their fixed exchange rate regimes encouraged excessive foreign borrowing by the private sector, especially commercial banks. The large influx of liquidity led to real estate bubbles and large maturity mismatches on bank balance sheets: long-term assets in the form of mortgages financed by short-term borrowing in foreign currency. The ensuing capital flight and drain on foreign exchange reserves had an impact on everyone in the affected economies and globally. These experiences have led to the development of new models of currency crises focusing on moral hazard, excessive foreign borrowing by the private sector and implicit government guarantees (see e.g. Corsetti et al., 1999). The concept of contingent public sector liabilities emerged, pointing analysts to incorporate different scenarios for economic and demographic development, or potential pressures for private sector bailouts into the analysis of government finances.

Arguably, both above-described frameworks – conventional public overspending versus spillovers of imbalances in private banks to public sector accounts – are applicable to the unfolding European financial crisis. For example, the case of Ireland in 2008 exhibited parallels with the 1997 Asian crisis: short-term foreign borrowing by banks, real estate bubbles and a revaluation of bank balance sheets leading to an impetus for a government bailout. As a result, government as a percentage of gross domestic product (GDP) shot up dramatically from 24.8 percent in 2007 to 65.2 percent in 2009 and 92.5 percent in 2010 (Source: Eurostat). In 2012, Spain is expected to follow this path as investors have started

to demand higher interest on sovereign borrowing in expectation of bank bailouts. On the other hand, as the analysis in the next section shows, Greece seems to fit within a more traditional public-sector triggered financial crisis and this begs the question: Why were the warning signs summed up in the fiscal performance data ignored for so long by investors and policymakers? While in the case of Greece there has been evidence emerging of some degree of cover-up and manipulation of budget deficit and debt figures,² their extent does not negate the fact that the published data should have raised alarm long before 2008.

In general, high public debt levels are cause for concern for several reasons. If the debt is denominated in foreign currency, any depreciation of the domestic currency will make it harder to repay the debt and increases the risk of default. If the debt is denominated in domestic currency, governments have incentives to inflate away the real burden of the debt. Historically, this has been the case in numerous developing countries, but also in European countries following the growth in deficits and debt as a result of the oil crisis of the late 1970s. High-income European countries and other member countries of the Organization for Economic Cooperation and Development (OECD) exhibited high inflation rates in the 1980s and early 1990s. The negative effects of high inflation are numerous and well documented. In fact, the inflationary experiences and persistent inflationary expectations motivated many European Union (EU) countries to give up

² See, for example, Bloomberg report “Goldman Sachs, Greece Didn’t Disclose Swap Contract (Update1)” by Elisa Martinuzzi, posted on February 17, 2010, available at: <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=asBNXSLtIN9E>

monetary policy, create the EMU and the European Central Bank (ECB) based on the conservative Bundesbank model.³

The dangers of excessive public debt under the EMU have been long recognized and led to the adoption of the Stability and Growth Pact (SGP) that set fiscal restrictions for individual members states. Nevertheless, as with any other international treaty, enforcement with respect to sovereign nation states remains a challenge, especially when most member countries have exceeded the 3 percent of GDP deficit and/or 60 percent of GDP public debt limits.

Even if some form of punishment for breaking the fiscal rules under the SGP is politically difficult, it should not prevent financial markets from imposing penalties in the form of credit rating downgrades and higher risk premia on government bonds. Since this channel also failed to work, the paper explores the reasons behind this financial market imperfection and potential solutions to it.

The paper is organized as follows: The next section explores the origins of the European crisis by analyzing fiscal data and reviewing the theoretical and empirical literature on the pros and cons of a monetary union. The paper also provides a critical analysis of

³ It also worth noting that the EMU has been substantially superior to the previous system of pegged exchange rates vis-à-vis the Deutsche Mark that reflected the desire to enhance monetary policy credibility and anchor inflationary expectations. A soft peg system is simply impossible to maintain in a world of free capital flows as we have become to know it since the 1990s. Such vulnerabilities also underlie the disincentives for joining ERM II as part of the pre-EMU accession requirements for EU members who would otherwise qualify to become part of the Eurozone (see Kimakova, 2009).

proposed policy responses and suggests alternative strategies for dealing with the current crisis and preventing future ones.

The origins of the European financial crisis

Most commentators on the so-called eurozone crisis refer to the theory of Optimum Currency Areas (OCAs) developed by Mundell (1961) and McKinnon (1963). According to this stream of research, a country is a good candidate to join a monetary union if strong trade links are present with other member countries, labor is mobile, shocks are synchronized across regions and fiscal transfers are available to help smooth out inequalities. Joining a monetary union also implies giving up monetary policy independence, but this should not entail a large opportunity cost for countries struggling with a history of inflation and lack of credibility.

Optimal regime choice has also been linked to the source of the economic shocks, real or nominal, and the degree of capital mobility. Following the works of Mundell (1963) and Fleming (1962), the main recommendations on regime choice included adopting a floating regime if real shocks prevail, while a fixed regime should be preferable under nominal shocks.

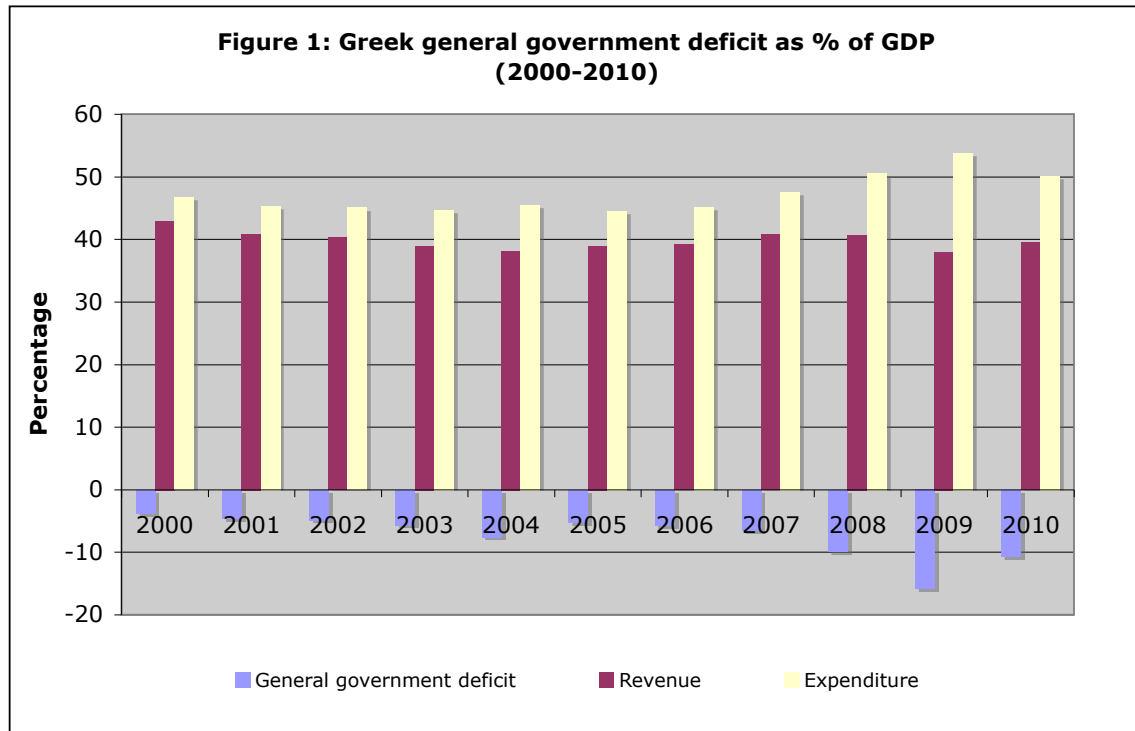
Later Frankel and Rose (1998) pointed towards the endogeneity of OCAs, or the fact that countries may become optimal candidates for a monetary union ex-post, after the implementation of a common monetary regime, even if they do not qualify ex-ante. The

reason is that the currency union may enhance trade and the correlation of shocks in member states.

Greece has been at the epicenter of the eurozone crisis and critics have argued that Greece should not have adopted the euro in the first place since it did not meet the OCA criteria. This raises the following questions: Did the adoption of the euro cause the economic woes of Greece? What would be the economic situation in Greece today if the country did not adopt the euro in 2001?

Real GDP growth in Greece in the 2001-2007 period averaged 4.1 percent per year, which was actually stronger than the EMU average of 2 percent per year for the same period (Source: Eurostat). The current account deficit to GDP ratio also improved until 2005. Hence, it would be hard to argue that EMU membership hurt the country's growth prospects or potential for generating tax revenue.

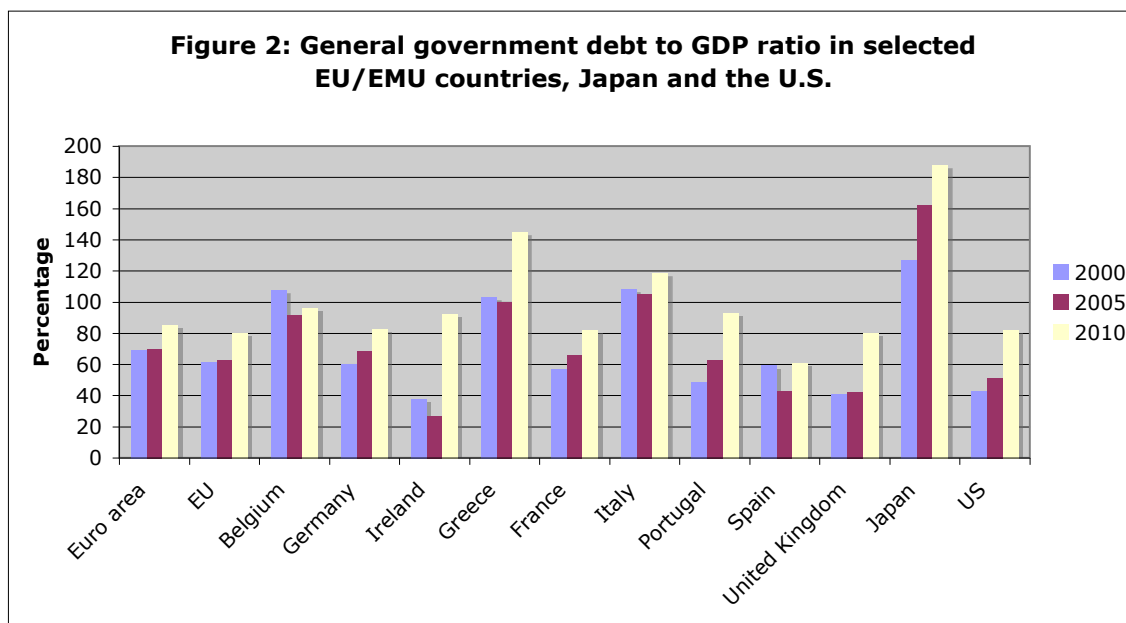
But, the fiscal situation in Greece paints a different picture. General government deficit deteriorated from 3.7 percent of GDP in 2000 to 7.1 percent of GDP by 2004. The government debt to GDP ratio hovered around 100 percent in the 2000-2006 period, and thus Greece did not actually meet the SGP criteria upon joining the EMU. Disaggregating the fiscal indicators shows that government expenditure at 45-50 percent of GDP systematically exceeded revenue, which was around 40 percent of GDP (See Figure 1, Source: Eurostat).



Mitsopoulos and Pelagidis (2011) argue that the main cause of Greece's fiscal problems lies in its structure of personal income taxation. The tax rates are highly progressive, but given a high degree of income inequality, overall tax collection is ineffective. The tax-exempt income threshold is high, very close to median income, which has resulted in almost half of Greek households paying no personal income tax. The burden of taxation falls heavily on salaried income, while the self-employed enjoy higher incomes, almost flat-rate social security contributions and more opportunities for under-reporting income. The tax system generates significant distortions in the labor market by discouraging salaried employment relative to self-employment. It is especially hostile to young labor market participants who do not have the capital to start-up self-employment and can be hired at below minimum wage levels under the umbrella of training programs, especially in the public sector.

Overall, the evidence points to structural imbalances in public sector finances as the source of the crisis in Greece. These problems would have been present even if Greece had not adopted the euro. In that case, the crisis would have manifested itself as a typical currency crisis involving capital flight, sharp currency depreciation and rise in inflation. The impact on the economy and the general population would have been severe, with inflation persisting and hurting primarily the lower income populations and pensioners. Fiscal cuts would have been just as unavoidable as they are today under debt restructuring deals.

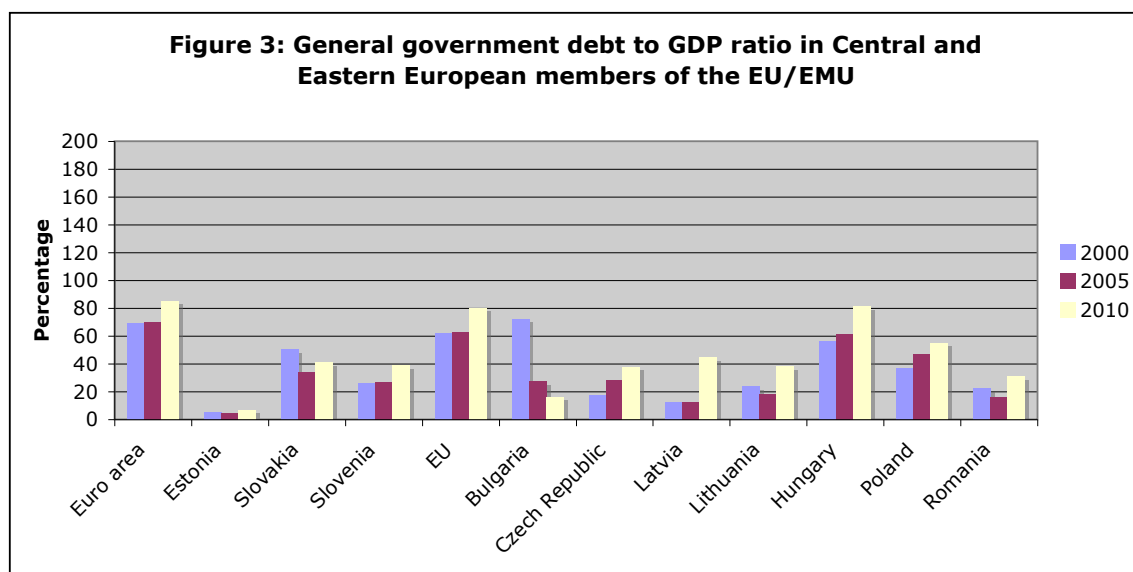
It is important to point out that besides Greece, many other OECD countries have excessive public deficit and debt levels, and the list is not limited to EMU members. Italy, Belgium, Portugal, Spain, France and other countries have seen their credit ratings downgraded, but the UK and U.S. also have public debt levels around 80 percent of GDP as of 2010, while for Japan the ratio stands near 200 percent of GDP (See Figure 2, Sources: Eurostat and ECB Statistical Data Warehouse). These economies have floating exchange rates and monetary policy independence as far as it is possible in a world of free capital mobility and high degree of financial integration. Nevertheless, fiscal consolidations seem just as unavoidable for them as they are for Greece.



Another relevant, but rarely applied, comparison is with respect to the experience of Central and Eastern European (CEE) countries. The CEE countries underwent a major economic transformation in their transition years from central planning to a market economy in the 1990s. While suffering massive contractions in output and high unemployment, they faced pressures from the International Monetary Fund (IMF) and the EU (as aspiring EU member states) to restructure their public sector and meet strict fiscal targets. As Figure 3 illustrates, CEE countries currently have the lowest public debt levels in the EU, well below the EU/EMU average. The only exception is Hungary, which has a history of high (and persistent) debt and inflation levels, and notably, has not adopted the euro.⁴

⁴ Among CEE countries only Estonia, Slovakia and Slovenia are currently part of the eurozone. For an analysis of some of the disincentives to adopt the euro, and the transitional Exchange Rate Mechanism (ERM) II in particular, see Kimakova (2009).

The experience of CEE countries shows that fiscal consolidations, even though politically unpopular, are possible in times of economic contraction and major restructuring. In fact, as fiscal positions deteriorate, meaningful action is typically only taken in a crisis environment when the marginal cost of waiting increases steeply to exceed the marginal costs of fiscal concessions.⁵ Politically, the CEE experience also explains why these countries have insisted on strict conditionality to be attached to the Greek bailout.



There is a growing body of empirical evidence pointing to fiscal policies as the source of the European financial crisis, while at the same time documenting the benefits of EMU membership. Lamo et al. (2012) find robust evidence that public consumption, wages, and employment in OECD countries from 1960 to 2005 have exhibited a positive correlation with the business cycle. They also point out that pro-cyclical discretionary fiscal policies have made a significant contribution to this outcome.

⁵ Alesina and Perotti (1995) provide an extensive overview of theoretical explanations why fiscal consolidations tend to be delayed for long periods of time.

Breedon et al. (2011) show that small rich economies face a relatively large degree of economic volatility compared to larger economies. Choosing a free float (or managed float) exchange rate regime does not help these economies to reduce volatility. This stands in contradiction to the theory developed by Mundell (1963) and Fleming (1962), and provides evidence that giving up monetary policy independence by joining a larger monetary union does not actually entail an opportunity cost for small open OECD economies.

The positive trade effects of adopting the euro (and in the run up to EMU membership) have been documented by a number of studies (see e.g. Berger and Nitsch, 2008; Cieslik et al., 2012). Ottaviano et al. (2009) also found that the euro increased the overall competitiveness of eurozone firms, especially for member countries smaller in size or with better access to foreign markets, in competitive sectors with low barriers to entry. Another dimension of monetary integration not captured by the traditional OCA framework is financial integration. A lot has changed since the 1960s when the theory was developed. Most notable among the developments is the high degree of international capital mobility, volume of transactions, financial deepening and integration that we have observed since the 1990s.

Coeurdacier and Martin (2007) analyze the impact of the euro on trade in bonds, equity, and banking assets. They find 10-17 percent lower transaction costs for bond and equity holdings as well as the elasticity of substitution between bonds inside the eurozone to be three times higher than between bonds denominated in different currencies. While this

implies potential benefits to EMU governments, corporations, and households through lower borrowing and transaction costs (and thus more investment and growth opportunities), it also hides a significant flaw in the functioning of financial markets. A number of studies provide consistent evidence that sovereign risk ratings and bond yields in EMU showed very little variation and did not reflect the country-specific fiscal situations (see e.g. Klepsch and Wollmershauser, 2011; Eichengreen, 2010; Barrios et al., 2009; Haugh et al., 2009). In other words, countries like Greece enjoyed relatively low costs of borrowing and favorable credit ratings that lagged behind market spreads rather than signalling for their change.

Investors failed to discipline governments for excessive debt levels through higher costs of borrowing and exposed themselves to a high degree of credit risk. Financial managers tend to point to bank regulations propagating the problem. Specifically, under the Basel Committee on Banking Supervision rules a bank can hold any sovereign bond issued in domestic currency as part of the level 1 pool of assets qualifying for the liquidity coverage ratio (LCR). Now the Basel Committee is considering including a rating component for qualifying assets under the LCR to differentiate between government bonds issued in the same currency, but of varying default risk (Watt, 2012). However, it remains unclear how rating agencies are expected to be turned around to be a useful source of information on the true degree of credit risk.

This paper provides a more detailed discussion on the subject of regulatory changes with respect to rating agencies and risk assessment in a subsequent section, but I would like to

emphasize that the Basel regulations or the bad performance by rating agencies do not absolve financial institutions of the responsibility for internal safeguards and risk assessment. The Basel regulations allowed banks to exploit loopholes, but did not prevent them from implementing more conservative, risk mitigating safeguards. This is especially true in an environment where rating agencies have been notorious for failing to adequately assess risk.

Overall, this analysis points to two factors as the main source of the European financial crisis: First is the lack of fiscal discipline and excessive debt levels by governments both in the EMU and outside the EMU. The second failure lies in inadequate risk assessment by financial institutions. It is debatable if this second problem stems from moral hazard, insufficient or flawed regulation, ineffective corporate governance or short-sighted trading and financial management practices.

Some bad ideas for the future of the euro

This section provides a brief overview of some of the most often mentioned new policy initiatives aimed at saving the eurozone and/or preventing future crises. The list is not exhaustive and the ideas are at different stages of formalization as policy proposals, actual agreements, or mere commentary. Nevertheless, it is important to analyze them due to their potential impact on market expectations and increasing uncertainty about future policy course at the very least.

- **Make the ECB more politically accountable** – A number of politicians and academics have called for the widening of the ECB mandate to include other policy objectives beside price stability. For example, EU commissioners have debated whether the mandate should extend to fostering growth and employment.⁶ And should the ECB be unwilling to comply with demands for policy flexibility by elected bodies, Eichengreen (2010, p. 43) has suggested that the European Parliament or even the group of finance ministers of eurozone member countries be given the authority to fire the ECB president or other members of the board.

Given everything that we know from economic theory and history, this suggestion clearly qualifies as the number one threat to the credibility, stability and future of the EMU. And it stands in direct contradiction to the motivation to create (or join) the EMU in the first place as a credibility enhancing institution for European economies struggling with fiscal dominance of monetary policy and persistent inflationary expectations.

- **Voluntary or forced exit from the EMU by some of its troubled members** – There is no legal provision for abandoning the EMU at any time. And there is a reason for that: Any potential for giving up the euro, reverting to a national currency (including partly or wholly converting outstanding debt into national currency) in a debt crisis would translate into inflationary expectations and their pricing into debt instruments, wage and other contracts. Such a scenario would most likely not be conducive to growth and may further exacerbate the government's fiscal position. And if outstanding debt – public or private –

⁶ See for example November 21, 2011 news release at <https://mninews.deutsche-boerse.com/index.php/eu-commissioners-debating-expanded-ecb-mandate?q=content/eu-commissioners-debating-expanded-ecb-mandate>.

would remain denominated in euros, its burden would only increase under pressures for currency depreciation. The debt burden and the probability of default would only increase in that case.

Some economists have suggested that Greece should follow the example of Argentina, which abandoned its currency board regime and peg to the U.S. dollar in 2002. They argue that even though the transition year was very harsh (output contracted, unemployment and inflation shot up), Argentina's growth performance has been stellar since then. This argument is simplistic and flawed for several reasons. In the run-up to the 2002 crisis, Argentina did not face major fiscal imbalances. Its currency was pegged to the U.S. dollar, which reflected on a history of capital flight and a degree of *de facto* dollarization of the economy (dollar-denominated debt). But, while Greek exports mostly go to eurozone countries, the U.S. was not a major trading partner for Argentina. As Brazil devalued its currency after the 1997 Asian crisis, the U.S. dollar appreciated against the euro, the Argentine peso appreciated and it negatively affected the country's export performance. Hence, for an overvalued exchange rate as the source of the problem in Argentina, a devaluation helped address it directly. But, even in light of high growth rates since then at around 9 percent per year (Source: World Development Indicators), we need to consider the impact of high inflation on welfare. The negative effect on household savings and poverty was massive: urban poverty ratio reached 54 percent in 2002 and remained above 20 percent until 2007 (Source: World Development Indicators).⁷

⁷ Rural poverty rates are not available for this period.

If Greece were to abandon the euro, the welfare impact would be similar. At the same time the potential benefits of a devaluation for growth remain questionable given the structural imbalances in the economy, and labor markets in particular. Adjustments to tax and labor market policies seem necessary to create conditions for growth. An aging population also suggests changes to pension entitlements, just as in other OECD countries. Exit from the EMU is unlikely to deal with these structural problems or to create better growth prospects. Recent political events in Greece are consistent with this view. Despite all the political turmoil and polarization, failed parliamentary elections in May 2012, the second round of elections in mid-June 2012 resulted in a pro-euro mandate for the new coalition government. Whether the bailout conditions will be renegotiated or not remains to be seen, but some degree of austerity and structural reform is unavoidable and the Greek public seems to give this necessity increasing recognition.

The Greek election results are also consistent with survey data on public support for the euro. Politicians and commentators often confuse disillusionment with the current state of economic affairs and policies as lack of support for the common currency. It would be indeed unrealistic to expect high policy approval rates in times of high unemployment and austerity measures, but when faced with the question of abandoning the euro and returning to the drachma, only 23 percent of Greeks were in favor. Similar survey results were recorded in other polled countries including France, Germany, Spain and Italy with the majority of the public committing to the euro rather than wishing for the return of their national currencies (Source: Pew Research Center, Q67, 2012).

Finally, it is also worth noting that if only one member state were actually to exit the EMU, it might induce spillover expectations with respect to other member states.

Different political groups may even have incentives to exploit the uncertainties created in such an environment. Consequently, staying in the EMU is the best available option to all member states individually and collectively.

• **Penalties on member countries for not meeting fiscal targets** – On March 2, 2012, twenty-five of the twenty-seven EU countries signed “The Treaty for Stability, Coordination and Governance,”⁸ which includes provisions for individual member countries adopting balanced-budget rules and penalties for non-compliance with set fiscal targets set not to exceed 0.1 percent of GDP. While any political and legal efforts to promote fiscal discipline are welcome, it is doubtful that the envisioned penalties for failure to comply will serve as an effective deterrent.

First, the magnitude of the proposed penalty seems rather negligible relative to the scale of current deficits and debts, or when weighed against the potential for domestic political backlash for cutting spending or increasing taxes. For some governments it may be simply more attractive to accept the penalty than implement fiscal consolidation. On the other hand, should the penalty be significantly higher, it would only further deteriorate the fiscal position of affected states, and hence exacerbate the crisis.

⁸ The Treaty needs to be ratified by at least 12 member states in order to come into effect on January 1, 2013. If states fail to ratify the Treaty, they become ineligible for bailout funding. The UK and the Czech Republic did not sign the Treaty.

- **More fiscal centralization** – There have been numerous calls for greater fiscal centralization in the EU/eurozone, especially on the revenue/financing side. For example, common Eurobond issuance has been suggested as a tool to reduce the cost of borrowing and limit perceived contagion effects of rising yield spreads on some member countries' sovereign debt issuance (see e.g. Favero and Missale, 2011; Claessens et al., 2012 for an overview of the literature on this subject).

While I certainly do not contend the benefits of deep and liquid financial markets, and Eurobond issuance may even have a calming effect on the markets in the short term, it is likely to be counterproductive in the medium to long term and prolong the current fiscal crisis. The reason is that national governments need the immediate disciplining effect of rising costs of borrowing to compel them to take action on fiscal consolidation.

Otherwise, moral hazard and free riding with respect to more fiscally conservative governments is likely to persist. Fiscal accounts will be more muddled across the EU, which will only diminish the informational efficiency of financial markets with negative implications for volatility, liquidity and financial deepening.⁹ Uncertainty in financial markets will persist, and the cost of borrowing may increase for the EU collectively in the longer term.

More broadly, calls for more fiscal centralization in the eurozone tend to be equated with support for the euro and vice versa. This is economically flawed and politically

⁹ Meaningful financial deepening can only take place through quality improvements (e.g. in terms of information disclosure, pricing of risk, creditor rights, low inflation and stable macroeconomic environment– see e.g. Dehesa et al., 2007) and governments can benefit from it not only by seeing their costs of borrowing decline, but also through the positive impact on private sector investment and growth.

dangerous. Any fiscal centralization proposal needs to be evaluated in detail on its own merit in terms of both efficiency and redistributive effects across member states. Lack of support for any such proposal should not be interpreted as flagging support for the euro. Otherwise, it can be exploited for political opportunism and will exacerbate uncertainty in financial markets along with government borrowing costs.

Alternative policy recommendations and implications for financial sector management

For any policy to successfully address the current situation in the EU/eurozone and to prevent future financial crises, it has to deal with the sources of the problems directly. It is clear from the analysis presented so far that assigning blame to the euro or the ECB is unhelpful. Instead, the main sources of the crisis lie in excessive public deficits and debt levels, delayed fiscal consolidations, mis-pricing of sovereign default risk levels by investors and rating agencies, and financial regulations and management techniques prone to propagating asset price bubbles.

Getting fiscal deficit and debt levels down to acceptable levels (i.e. to meet the SGP criteria) is not going to be an easy task for a multitude of reasons. Clearly, the easiest way (politically and economically) out of the fiscal crisis would be through economic growth that would decrease the debt-to-GDP ratio. For example, pro-growth policies that help eliminate labor market distortions and boost employment levels would be most welcome in many EMU countries. Dealing with structural unemployment, especially youth unemployment, has the potential for greatest payoff.

In the shorter to medium term though, fiscal consolidation is a must. But fiscal consolidation amidst an economic downturn remains a widely unpopular and politically contentious issue that is not universally supported by economists either. For example, Paul Krugman and others have expressed concern about a possible contractionary effect of budget cuts, thus deepening the crisis. Can the empirical literature shed light on this controversial issue? While estimated fiscal multipliers tend to be in general positive yet small,¹⁰ non-linear effects with respect to public debt levels are a crucial consideration here. Specifically, are expansionary fiscal consolidations more likely when public debt levels are deemed excessively high and countries face an economic crisis? The empirical evidence in the literature points to a positive answer to this question: Bergman and Hutchinson (2010), Afonso (2006), Ardagna (2004), Giavazzi et al. (2000), Alesina and Ardagna (1998), Bradley and Wheelan (1997), Alesina and Perotti (1997) find evidence of non-Keynesian effects of fiscal policy when initial debt levels are high (also called the ‘German’ view). The findings relate to high-income economies typically, whether in the context of individual country case studies (e.g. Denmark and Ireland in the 1980s) or panel data for a subset of OECD countries. The studies also indicate that only credible, large fiscal consolidations yield positive economic results. In terms of potential political costs to governments implementing large fiscal adjustments, Alesina and Ardagna (1998) even found that governments taking such action typically managed to remain in office.

¹⁰ See e.g. Hemming et al. (2002) for an overview of the literature on the effectiveness of fiscal policy in stimulating economic activity. Most of the empirical findings in the literature relate to OECD countries. Estimates of fiscal multipliers are typically positive yet small, and government spending multipliers are systematically larger than those of tax cuts.

So how can we explain the occurrence of expansionary fiscal contractions? Sutherland (1997) and Barry and Devereux (2003) provide theoretical frameworks to address this issue. Sutherland (1997) builds on the work by Bertola and Drazen (1993) and shows that consumers incorporate expectations of higher taxes into their consumption/saving decision when debt levels reach critical levels. Therefore, fiscal adjustments that reduce expectations of tax hikes have a positive effect on private consumption (i.e. Ricardian equivalence applies). Barry and Devereux (2003) provide a dynamic general equilibrium analysis of the matter and highlight the importance of the interest rate channel: a permanent reduction in government spending yields lower real interest rates, which boosts employment and output both in the short and long term. Moreover, this effect is non-linear as the gains in output are larger when initial government spending is especially high. Ardagna (2009) provides empirical evidence in support fiscal adjustments reducing interest rates and raising stock prices.

Even though the evidence consistently points to the size of the fiscal adjustment to be a factor in determining its success, the findings with respect to the composition of the adjustment are mixed. For example, Alesina and Perotti (1997), Ardagna (2009), and Alesina and Ardagna (2010) found spending cuts to be conducive to debt reduction rather than tax increases, while Giorgioni and Holden (2003) concluded the opposite. I suppose the only reasonable recommendation is to look for the sources of structural imbalances in fiscal accounts to arrive at meaningful context-dependent solutions for individual countries.

But for now, the common theme across countries remains the resistance to fiscal adjustment and delay in reforms. Alesina and Perotti (1995) provide an extensive overview of theoretical explanations why fiscal consolidations tend to be delayed for long periods of time. As fiscal positions deteriorate, meaningful action is typically only taken in a crisis environment when the marginal cost of waiting increases steeply to exceed the marginal costs of fiscal concessions. From this perspective, continued pressure from investors in the form of higher required bond yields is necessary to maintain the political momentum for reform. A quick easing of financial conditions would be actually counterproductive.

Another example of an environment conducive to fiscal consolidation is when there is little political uncertainty about re-election prospects. In such a case, incumbent politicians are more likely to internalize the government's intertemporal budget constraint and bring it under control. A case in point is Canada's experience during the 1990s when the Liberal Party enjoyed a prolonged period of political success, and thus had all the right incentives to deal with large deficit and debt levels accumulated during the 1980s faster than any other OECD government. However, such situations are admittedly very rare. Most politicians tend to be myopic, disregard the costs of delayed consolidations, and behave strategically to maximize re-election prospects and/or minimize the burden on their constituency. Coalition governments further enhance these obstacles to consolidation. Consequently, short of a stable political outlook for incumbent governments, the only realistic, most immediate, disciplining factor remains in the realm

of financial markets. Credit rating downgrades and higher costs of borrowing are crucial to compel governments to implement budget cuts.

However, empirical evidence shows that credit rating agencies have failed miserably to fulfill their role and independently signal to investors the true degree of default risk involved in government securities (see e.g. Klepsch and Wollmershauser, 2011; Eichengreen, 2010; Barrios et al., 2009; Haugh et al., 2009). There are no easy solutions to get credit rating agencies on the right track. More government regulation is unlikely to be helpful in this case because governments have a conflict of interest in their dual role as regulators and borrowers. For this reason, there has been historically relatively little government oversight of rating agencies.

In fact the latest trend in regulation emerging from the U.S. under the 2010 Dodd-Frank Act is to move away from reliance on rating agencies altogether and remove any references to them from financial regulations. In this scenario, financial institutions would be responsible for conducting their own risk assessment, which has its advantages and disadvantages. On hand, it would force financial institutions to take more responsibility for risk assessment, hopefully leading them to take a closer look at the issue. On the other hand, some conflicts of interest are likely to remain and costs will also increase. From an aggregate efficiency point of view, reliance on rating agencies had the potential benefit of avoiding duplication and cost savings, but it did not deliver in terms of quality. Furthermore, to deal with conflicts of interest in terms of financial institutions

potentially over-selling financial products to clients for their own benefit, the strengthening of fiduciary duties and their enforcement seems to be a must.

Since the financial sector is well known for product innovation and resourcefulness when it comes to circumventing controls, a general move away from playing catch-up with product restrictions to focus on conduct regulation is likely to be beneficial. After all, most financial crises can be traced back to imprudent or outright fraudulent practices at their core. The enforcement of fiduciary duties is nevertheless likely to remain difficult. Both public and private enforcement through litigation should be considered in order to enhance the effectiveness of enforcement and raise the level of expected punishment.

An overarching implication for policymakers is to improve the quality of publicly available information on borrowers and issuers of securities in general. Starting with the public sector at all levels and branches of government and affiliated agencies, the publication of detailed spending and liability information would not only provide a more accurate picture of the state of public finances, but it would likely also enhance accountability to taxpayers. For example, greater transparency could lead to savings through the elimination of inefficient or corrupt spending practices. Furthermore, the lesson for analysts of public sector finances is to include in their risk assessment scenarios for contingent government liabilities. Recent bailouts of financial institutions and car manufacturers in the U.S. serve to illustrate the point. Events like this can alter the fiscal situation of any government in a very short period of time.

Financial institutions and their shareholders also ought to scrutinize their management practices. Moral hazard remains a problem as governments tend to protect the viability of financial institutions through debt restructuring rather than allowing default to significantly affect their balance sheets and spill over to the rest of the economy. New government regulations on capital adequacy or other practices are also unlikely to eliminate the potential for crises without internal changes to financial management. For example, to limit the tendency to propagate asset price bubbles, portfolio managers should be evaluated by their employers based on longer term performance measures in addition to the standard quarterly or annual data.

Conclusions

The analysis in this paper shows that the sources of the European financial crisis lie in systematic fiscal imbalances, and the failure of rating agencies and investors to adequately assess and price sovereign and private mortgage default risk. The crisis cannot be linked to EMU membership – either through the adoption of the euro or the delegation of monetary policy to the ECB. Therefore, labelling the current crisis as a “eurozone crisis” or “failure of the euro” is misleading, and potentially costly by misguiding policy responses and propagating uncertainty in financial markets with respect to exchange rate and credit risks.

A number of high income OECD countries currently face high public debt levels, not just EMU member states. Fiscal consolidations and pro-growth policies are imperative to stabilize financial markets and economic prospects. On the other hand, a number of

prominent policy proposals analyzed in this paper are unlikely to yield positive results, and have the potential to inflict more harm. For example, changes to the ECB mandate, abandoning the euro or issuing Eurobonds fall into this category.

The paper also provides alternative policy recommendations and suggestions for financial management. The common element among these is that they aim to address the sources of the crisis rather than some of its symptoms. The recommendations include fiscal consolidations, greater transparency in public finances, and more discriminating pricing of government bonds to induce fiscal discipline. Financial institutions ought to internalize risk assessment, re-assess trading and remuneration practices to enhance accountability to their clients and shareholders. Strengthening fiduciary duties rather than focusing on ever elusive product regulations has the greater potential for exerting meaningful change in financial management and averting future crises.

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